

S Corporation Questions & Answers

Provisions in Chapter 173, P.L. 1993 provide that a corporation may elect to be treated as a New Jersey S corporation. The following is designed to address the most commonly asked questions regarding S corporations.

1. *When is the S election available?*

The election is available for fiscal and calendar years beginning after July 7, 1993. The first calendar year for which the S election could be made was 1994.

2. *How is the S election made?*

A corporation must file Form CBT-2553 to elect to be treated as a New Jersey S corporation, a New Jersey QSSS, or to report a change in shareholders.

3. *How much time does a taxpayer have to file the election?*

Corporations have one month beyond the time to file a Federal election under Internal Revenue Code (IRC) Sec. 1362 in which to file a New Jersey election. IRC Sec. 1362 provides that the election must be made by the 15th day of the third month of the taxable year. Taxpayers therefore have until the 15th day of the fourth month of the tax year (April 15 for calendar year taxpayers) to file the New Jersey S election form.

4. *Is it necessary to file the S election form in order to be treated by New Jersey as an S corporation? Assume a New Jersey corporation, which has elected S corporation status for Federal tax purposes, makes no affirmative election to be treated as an S corporation for New Jersey purposes. Would New Jersey simultaneously tax the corporation at the 9% rate and tax the resident shareholder at his top marginal rate on his pro rata share?*

Yes. A corporation which is an S corporation for Federal purposes but does not elect S corporation status for State purposes would be subject to the corporate tax rates for ordinary corporations, 9%, 7½%, or 6½%. The resident shareholder would be taxed on the net pro rata share of S corporation income, which in this case would be the Federal S corporation's income *not* allocated to New Jersey, based on the gross income tax rate schedules.

5. *Is it necessary for all shareholders to consent to the S election?*

Yes. For the election to be valid, the corporation and all present shareholders, referred to as initial shareholders, must consent to the election and the jurisdictional requirements of the State. The corporation will be required to pay tax, at the highest marginal tax rate, on the pro rata share of S corporation income allocated to New Jersey for subsequent shareholders who fail to consent to the New Jersey jurisdictional requirements, N.J.S.A. 54:10A-5.22 and 5.23.

6. *Is it necessary for the corporation to be a Federal S corporation in order to be able to take the New Jersey S election?*

Yes. A New Jersey S corporation is a corporation that is an S corporation as defined by IRC Sec. 1361 and has made a valid New Jersey election, N.J.S.A. 54:10A-4(o) & (p) and N.J.S.A. 54:10A-5.22.

7. *What is the procedure for revoking the election?*

Once an election is made, a corporation remains a New Jersey S corporation as long as it is a Federal S corporation. There is a limited opportunity to revoke an election only during the first tax year to which an election would otherwise apply. To revoke an election, a letter of revocation signed by shareholders holding more than 50% of the outstanding shares of stock on the day of the revocation should be filed on or before the last day of the first tax year of the election. A copy of the original election should accompany the letter of revocation. Such a revocation will render the original election null and void from inception.

8. *Can a corporation elect S status, then revoke S status at the end of the year, then again elect S status in the following year?*

Yes, at the present time. However, under a possible future legal change, an S corporation which revokes its S status would be prevented from reelecting S status for 5 years, similar to IRC Sec. 1362(g). If such a change is made, the public will be notified.

9. *If shareholders of a Federal S corporation doing business in New Jersey make an election to be treated as a New Jersey S corporation, what treatment is accorded the undistributed corporate earnings?*

The undistributed corporate earnings are not subject to tax at that point in time. However, the balance just prior to the effective date of the New Jersey S corporation election will become New Jersey earnings and profits and will be a taxable dividend when distributed to a resident shareholder.

10. *Are reportable S corporation losses deductible against other New Jersey taxable income on the shareholder's gross income tax return?*

No. S corporation losses and income are included in the category of income "Net pro rata share of S corporation income." This category is a net amount of the S corporation income and losses. A net loss from S corporations is not deductible against other categories of income because under the Gross Income Tax Act, losses from one category of income cannot be used to offset income in another category, N.J.S.A. 54A:5-2.

11. *Assume a New Jersey resident is a 100% shareholder of a Federal and New York State S corporation. This corporation does not do business in New Jersey, and currently does not and is not required to file a New Jersey corporation business tax return. Does the resident shareholder report the S corporation income (flow through items) on his New Jersey income tax return (NJ-1040)? Is the resident shareholder required to file a New Jersey S corporation election?*

The resident shareholder is required to report on his NJ-1040 his pro rata share of the Federal S corporation's income not allocated to New Jersey. The shareholder is not required to file a New Jersey S corporation election.

- 12. *Is there any built-in gains tax for New Jersey for electing S status as there can be for Federal purposes and, if so, is there a transitional period which would exempt such a tax (IRC Sec. 1374 (d)(3), or IRC Sec. 1375 (b)(1)(B)) such as was allowed at the Federal level?***

To the extent that Federal tax laws impose a corporate level tax on certain S corporation income (for example, pursuant to IRC Sec. 1374 on built-in gains or IRC Sec. 1375 on passive investment income), the New Jersey tax will be imposed at the full 9% New Jersey corporation level, N.J.S.A. 54:10A-5(c)(3). For purposes of the Federal 10-year “recognition period” for recognizing built-in gains, the S corporation may recognize the Federal built-in gain for New Jersey purposes to the same extent it is recognized on the current year Federal return. The S corporation is not required to report built-in gain from prior years.

- 13. *If a nonresident shareholder sells New Jersey S corporation shares, what is his gain? Does he pay tax on the gain?***

A nonresident shareholder will not have a gain or loss under N.J.S.A. 54A:5-1(c). The sale or disposition of S corporation stock is a transaction involving an intangible asset which is not taxable for a nonresident for gross income tax purposes under N.J.S.A. 54A:5-8. If, however, the nonresident has income from other New Jersey sources in the year he sells his New Jersey S corporation stock, he must calculate his gain from the sale as if he were a resident and include the gain in his income from all sources in Column A on Form NJ-1040NR.

- 14. *Can a permanent resident holding a green card become a shareholder or officer in an S corporation? Can a resident alien become a shareholder or an officer of an S corporation?***

The answer to both questions is yes. The “S corporation” standing is a tax status available to certain corporations. Shareholders of S corporations who are resident aliens would be liable for personal income taxes.

- 15. *What is the tax rate for S corporations?***

Generally, for Federal tax purposes, S corporations are not taxed at the corporate level. Instead, the income “flows through” to the individual shareholders who are then taxed on the income under the individual income tax. Thus, the Federal S corporation tax treatment eliminates the double taxation of income for most income earned by S corporations. The New Jersey S election statute does not completely eliminate the New Jersey corporation business tax for corporations electing New Jersey S corporation status. However, the statute does provide for a reduced corporate tax rate based on the difference between the highest personal income tax rate and the corporation business tax rate.

As of January 1, 2004, the corporation business tax rates are 9%, 7½%, or 6½% depending on income levels. The highest personal income tax rate is 8.970% for tax years beginning on or after January 1, 2004.

The tax rates for a New Jersey S corporation are as follows:

Entire Net Income	Periods Ending		Rate*
	<i>on or after</i>	<i>but on or before</i>	
In excess of \$100,000	July 1, 2001	June 30, 2006	1.33%
	July 1, 2006	June 30, 2007	0.67%
	July 1, 2007		0%
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\$100,000 or less for a 12-month privilege period**	July 1, 2001		0%

* On entire net income not subject to Federal income tax, as allocable to New Jersey.

** A corporation having an accounting period of less than 12 months may qualify for this reduced rate if its prorated income does not exceed \$8,333 per month.

To the extent that Federal tax laws impose a corporation level tax on certain S corporation income (for example, pursuant to IRC Sec. 1374 on built-in gains or IRC Sec. 1375 on passive investment income), the New Jersey tax will be imposed at the full 9% New Jersey corporate level.

A corporation doing business in New Jersey which does not make the election to be a New Jersey S corporation will continue to be taxed as a C corporation for New Jersey corporation business tax purposes and, therefore, will be subject to the 9% tax rate on all of its entire net income allocable to New Jersey, N.J.S.A. 54:10A-5(c)(1).

16. *Does the corporation business tax minimum tax apply to S corporations?*

Yes. The statute authorizing the S election also raised the minimum tax as follows:

Return Period	Domestic Corporation	Foreign Corporation
1993	\$ 25	\$ 50
1994	50	100
1995	100	200
1996	150	200
1997–2000	200	200
2001 (<i>begins prior to 1/1/02 – ends on or before 6/30/02</i>)	200	200
2001 (<i>begins 1/1/02 – ends on or before 6/30/02</i>)	210	210
2002 (<i>begins prior to 1/1/02 – ends on or after 7/31/02</i>)	200	200
2002 (<i>begins 1/1/02 – ends on or after 7/31/02</i>)	500 or 2,000*	500 or 2,000*

*\$2,000 rate applies if taxpayer is member of an affiliated group whose total payroll is \$5,000,000 or greater.

In the fifth year following calendar year 2002, and each fifth year thereafter, the minimum tax will be adjusted by multiplying the minimum tax for periods beginning in 2002 by an amount equal to one plus 75% of the increase, if any, in the annual average total producer price index for finished goods published by the Federal Department of Labor, Bureau of Labor Statistics, for the year preceding the determination year over such index for calendar year 2001, N.J.S.A. 54:10A-5(e).

17. *If a C corporation has a net operating loss (NOL) carryover, to what extent can it continue to be utilized if the shareholders make the New Jersey S election?*

The NOL can be used to reduce corporate income subject to the corporation business tax under provisions found at N.J.S.A. 54:10A-4(k)(6). The NOL deduction would be taken into account in computing entire net income (the tax base subject to allocation and tax in New Jersey for New Jersey S corporations for corporation business tax purposes).

The NOL cannot be used on the personal income tax return. There is no provision to permit an individual taxpayer to carry forward or carry back an S corporation operating loss on his or her individual return.

18. *Will a New Jersey S corporation that sells its assets and liquidates be subject to a double tax (gain or loss at corporate level as well as gain or loss at shareholder level)? Double tax is not applicable at the Federal level for S corporations under IRC Sec. 1374(d).*

Yes. Tax will be imposed at the corporate level at the reduced S corporation rate and the individual shareholders will be subject to gross income tax at their applicable rate.

19. *If an S corporation is not on a calendar year, is it required to make payments to New Jersey similar to those required by IRC Sec. 7519?*

No. An S corporation must generally use the calendar year unless it can establish a business purpose for having a different tax year. New Jersey law has no similar provision relating to such required payments, and accordingly they are not required under New Jersey law.

20. *Are corporation tax investment tax credits and Urban Enterprise Zone (UEZ) employee tax credits passed through to S corporation shareholders or taken at the corporation tax level?*

Investment tax credits and UEZ employee tax credits would be applied by the S corporation against the S corporation tax. They would not be passed through to shareholders.

21. *Assume a New Jersey corporation has received S status in New Jersey, but is subject to tax in California and Georgia because those states do not recognize S corporations. Does the shareholder get a credit for the corporation tax paid to those states?*

No, the shareholder is not entitled to a credit on Form NJ-1040 for corporation tax paid to other states. But if the corporation has a regular place of business outside of New Jersey, it can allocate. Otherwise it may be eligible for the credit for taxes paid to other states as a "Section 8 adjustment," N.J.A.C. 18:7-8.3.

22. *Assume a corporation is a Pennsylvania corporation whose shareholders have elected to be treated as an S corporation for both Federal and Pennsylvania income tax purposes. The corporation has two shareholders, one residing in Pennsylvania and the other in New Jersey. The corporation is not required to file corporate tax returns in New Jersey since it does not have nexus in New Jersey. Does the corporation qualify to elect S status for New Jersey tax purposes?*

Yes, the corporation qualifies to elect New Jersey S status but since it has no nexus with New Jersey it is questionable whether the corporation would do so.

Differentiate the taxability for New Jersey tax purposes, of corporate profits and dividend payments for the resident and nonresident shareholders of this particular corporation.

Pro rata share of S corporation income is defined in N.J.S.A. 54A:5-10. A resident shareholder of a Federal S corporation which does not make the New Jersey S election would be subject to tax on his pro rata share of S corporation income that is not allocated to New Jersey. Under the facts of this question all of the resident shareholder's pro rata share of the corporation's income is allocated outside of New Jersey and would be subject to tax.

The nonresident shareholder would not be subject to tax on any portion of the nonelecting S corporation's income.

Dividend payments for an S corporation are defined at N.J.S.A. 54A:5-1(f) as any distribution in cash or property made by an S corporation, as specifically determined pursuant to N.J.S.A. 54A:5-14. N.J.S.A. 54A:5-14(a) relates the distribution to IRC Section 1368 to the extent it would be treated as a dividend or as a gain under that section. A resident shareholder would be subject to tax on any dividend paid to him. A nonresident shareholder would not be subject to tax on any dividend paid to him.

Presuming the corporation is profitable, would the resident shareholder be allowed a credit for taxes paid to Pennsylvania on the Pennsylvania S corporation net income which is taxed by Pennsylvania?

Under N.J.S.A. 54A:4-1(a) the New Jersey resident shareholder would be eligible for a credit on Form NJ-1040 for taxes paid to Pennsylvania on his pro rata share of the S corporation's income which is subject to tax by both New Jersey and Pennsylvania.

23. *What are the New Jersey income tax responsibilities of nonresident shareholders of a New Jersey S corporation?*

Nonresident taxpayers will report their pro rata share of S corporation income allocated to New Jersey of the New Jersey S corporation, pursuant to N.J.S.A. 54A:5-8(6).

- 24. *If the New Jersey S election is not made, will the State of New Jersey in addition to taxing the corporation's income, also tax the distributions to resident shareholders?***

The taxability of a distribution from a Federal S corporation which has not made the New Jersey S election is first determined based on the corporation's New Jersey allocation factor.

The taxability of the distribution from income allocated outside of New Jersey is determined by using the shareholder's New Jersey adjusted basis, New Jersey Accumulated Adjustments Account (AAA) and New Jersey Earnings & Profits (E&P) and is governed by IRC Sections 1368 and 1371.

See the *S Corporation Decision Matrix* on pages 9–10 for examples of New Jersey resident shareholders of Federal S corporations that have not made the New Jersey S corporation election.

- 25. *An Indiana corporation, doing business solely in Indiana, elected S corporation status in 1993 for both Federal and Indiana tax purposes. The shareholder is a New Jersey resident. On his 1993 New Jersey resident tax return the shareholder reported the actual distributions received as taxable corporate dividends and did not report the S corporation income. On his nonresident Indiana return he reported and paid tax to Indiana on S corporation income derived from Indiana. In 1993, is the shareholder eligible for a credit for tax paid to Indiana?***

Yes. Since the distribution taxed by New Jersey and the S corporation income taxed by Indiana are in effect the same dollars, the resident would be eligible for a credit for taxes paid to Indiana on the income subject to tax by both jurisdictions.

For tax year 1994 and forward, assuming the same facts, the shareholder would report the S corporation's income derived from Indiana sources on his New Jersey resident return and would be eligible for a credit for taxes paid to Indiana on income subject to tax by both New Jersey and Indiana. The taxability of any actual distributions received by the shareholder would be determined using the shareholder's New Jersey adjusted basis, New Jersey AAA and New Jersey E&P and is governed by the priority system established in IRC Section 1368 and 1371.

- 26. *Assume a New Jersey resident owns 100% of the shares of a corporation which elected Federal S corporation status in 1995. The corporation's Retained Earnings on December 31, 1997, are \$25,000. A New Jersey S election is made effective January 1, 1998. For 1998, the corporation has net income of \$80,000 and distributes \$90,000 to the shareholder. What does the shareholder report on his New Jersey resident return?***

The shareholder will report \$80,000 in the income category net pro rata share of S corporation income.

The taxability of a distribution from an S corporation is addressed in N.J.S.A. 54A:5-1(f) and 5-14 and is determined by using the shareholder's New Jersey adjusted basis, New Jersey AAA and E&P and is governed by the priority system established in IRC Section 1368 and 1371.

The distribution from the shareholder's AAA, \$80,000, is not reportable. The \$10,000 distribution in excess of the AAA balance is applied to the shareholder's E&P account and is reportable in the income category dividends.

	Distribution	New Jersey AAA	New Jersey E&P
Beginning balance 1/98		0	\$25,000
1998 income		\$80,000	
1998 distribution	\$90,000		
Applied to AAA	(80,000)	(80,000)	
Applied to E&P	(10,000)		(10,000)
12/31/98 balance	<u>0</u>	<u>0</u>	<u>\$15,000</u>

27. *Does depreciation pass through to the shareholders?*

Depreciation as allowed under the Gross Income Tax Act is used in determining the shareholder's pro rata share of S corporation income reportable for gross income tax purposes. Depreciation adjustments required under the New Jersey Corporation Business Tax Act or any other state's law do not affect the shareholder's New Jersey net pro rata share of S corporation income.

S Corporation Decision Matrix For State of New Jersey

Shareholder Residency Status	Percentage of Shares Owned	Federal Status	New Jersey Election Status for Corporate Entire Net Income N.J.S.A. 54:10A-4(k)	S Corporation Income Allocated to New Jersey N.J.S.A. 54:10A-6, 10 N.J.S.A. 54A:5-10c	Shareholder's Pro Rata Share of S Corporation Income Subject to Tax (assumes \$100 income) N.J.S.A. 54A:5-10
Resident	50%	S	New Jersey S corporation (CBT-100S New Jersey allocated corporate income taxed at 2.350% as of 1/1/94 N.J.S.A. 54:10A-5(c)(2)&(3))	Allocating corporation (0% to New Jersey)	50% of \$100 = \$50 (S corporation income not allocated to New Jersey N.J.S.A. 54A:5-10)
				Allocating corporation (70% to New Jersey)	50% of \$70 = \$35 (S corporation income allocated to New Jersey N.J.S.A. 54A:5-10) + 50% of \$30 = \$15 (S corporation income not allocated to New Jersey; N.J.S.A. 54A:5-10)
				Nonallocating corporation (100% to New Jersey)	50% of \$100 = \$50 (S corporation income allocated to New Jersey N.J.S.A. 54A:5-10)
Nonresident	50%	S	New Jersey S corporation (CBT-100S New Jersey allocated corporate income taxed at 2.350% as of 1/1/94 N.J.S.A. 54:10A-5(c)(2)&(3))	Allocating corporation (0% to New Jersey)	50% of 0 = 0 (S corporation income allocated to New Jersey N.J.S.A. 54A:5-8(6))
				Allocating corporation (70% to New Jersey)	50% of \$70 = \$35 (S corporation income allocated to New Jersey N.J.S.A. 54A:5-8(6))
				Nonallocating corporation (100% to New Jersey)	50% of \$100 = \$50 (S corporation income allocated to New Jersey N.J.S.A. 54A:5-8(6))
Resident	50%	S	Not New Jersey S corporation (CBT-100 New Jersey allocated corporate income taxed at 9% as of 1/1/94 N.J.S.A. 54:10A-5(c)(1))	Allocating corporation (0% to New Jersey)	50% of \$100 = \$50 (S corporation income not allocated to New Jersey N.J.S.A. 54A:5-10)
				Allocating corporation (70% to New Jersey)	50% of \$30 = \$15 (S corporation income not allocated to New Jersey N.J.S.A. 54A:5-10)
				Nonallocating corporation (100% to New Jersey)	50% of 0 = 0 (S corporation income not allocated to New Jersey N.J.S.A. 54A:5-10)

S Corporation Decision Matrix For State of New Jersey (continued)

Shareholder Residency Status	Percentage of Shares Owned	Federal Status	New Jersey Election Status for Corporate Entire Net Income N.J.S.A. 54:10A-4(k)	S Corporation Income Allocated to New Jersey N.J.S.A. 54:10A-6, 10 N.J.S.A. 54A:5-10c	Shareholder's Pro Rata Share of S Corporation Income Subject to Tax (assumes \$100 income) N.J.S.A. 54A:5-10
Nonresident	50%	S	Not New Jersey S corporation (CBT-100 New Jersey allocated corporate income taxed at 9% as of 1/1/94 N.J.S.A. 54:10A-5(c)(1))	Allocating corporation (0% to New Jersey)	None (No New Jersey nexus or jurisdiction)
				Allocating corporation (70% to New Jersey)	None (Not taxed under N.J.S.A. 54A:5-8(6) since not a New Jersey S corporation)
				Nonallocating corporation (100% to New Jersey)	None (Not taxed under N.J.S.A. 54A:5-8(6) since not a New Jersey S corporation)
Resident	50%	C	Not New Jersey S corporation (Cannot elect since not Federal S. CBT-100 New Jersey allocated corporate income taxed at 9% as of 1/1/94 N.J.S.A. 54:10A-5(c)(1))	Allocating corporation (0% to New Jersey) (minimum CBT payer)	Shareholder taxed only on dividend paid (N.J.S.A. 54A:5-1f)
				Allocating corporation (70% to New Jersey)	Shareholder taxed only on dividend paid (N.J.S.A. 54A:5-1f)
				Nonallocating corporation (100% to New Jersey)	Shareholder taxed only on dividend paid (N.J.S.A. 54A:5-1f)
Nonresident	50%	C	Not New Jersey S corporation (Cannot elect since not Federal S. CBT-100 New Jersey allocated corporate income taxed at 9% as of 1/1/94 N.J.S.A. 54:10A-5(c)(1))	Allocating corporation (0% to New Jersey) (minimum CBT payer)	Shareholder not taxed on dividend paid; no jurisdic- tion over shareholder
				Allocating corporation (70% to New Jersey)	Shareholder not taxed on dividend paid; no jurisdic- tion over shareholder
				Nonallocating corporation (100% to New Jersey)	Shareholder not taxed on dividend paid; no jurisdic- tion over shareholder